MONTANA
MONEY SCHOOL
State Auditor John Morrison

Mutual Funds

Millions of investors have come to rely on mutual funds as their primary investments. Their growth has been explosive, with individuals, retirement plans and other investors putting more than $1 trillion in mutual funds by the mid-90s.

As with any investment, you should understand the nature and risks of mutual funds and available options before you invest. This information is condensed from "The Informed Investor" by the North American Securities Administrators Association (NASAA). Visit the investor education section/investor tips on the NASAA Web site at http://nasaa.org for more information on mutual funds.

What is a Mutual Fund?

Mutual funds belong to a class of firms known as investment companies. While companies may offer a "family" of funds under a single umbrella name and common administration - the Vanguard Group, Fidelity Investments or Strong Funds - each fund offered is a separately incorporated investment company. These companies pool investor money to buy securities, giving each investor the benefits that come from the ownership of a diversified portfolio of securities chosen and monitored daily by experienced, professional advisers.

The funds create and sell new shares on demand. Investors' shares represent a portion of the fund's portfolio and income proportional to the number of shares they buy. Individual shareholders of mutual funds have voting rights in the operation of the fund.

A key feature of mutual funds is that an investor can "cash in," or redeem his or her shares at any time. Mutual funds, therefore, are considered a liquid investment. The investor's selling price may be higher or lower than the purchase price, depending on the performance of the fund's portfolio.

The fund has an adviser who charges a fee for managing the portfolio. The adviser decides when and what securities to buy and sell, and is responsible for the fund's day-to-day operations. All fund investors get this built-in portfolio management whether they own 50 shares or 10,000.

The adviser generally buys many different securities for the portfolio since investment theory holds that diversification reduces risk. A fund also has a custodian, usually a financial institution such as a bank, which holds all the cash and securities for the fund.

Mutual funds are regulated by the federal Securities and Exchange Commission and the Securities Department in the Montana State Auditor's Office.

Types of Mutual Funds

Mutual funds can be classified by their investment objectives and the types of securities they hold.

Aggressive Growth Common Stock Funds invest primarily in common stocks to maximize capital gains. They may invest in out-of-favor companies or companies in new industries. Current income, or dividends, is not a significant factor.

Income Funds seek a high level of current income by investing in equity securities (generally high-yielding common and preferred stocks) and debt instruments (e.g., high-yielding bonds).

Money-Market Funds invest in securities with short-term maturities. Portfolios can include commercial paper issued by corporations, negotiable certificates of deposit, short-term corporate obligations, and U.S. government issued or backed securities, such as Treasury bills and notes.

Corporate Bond Funds seek income by investing primarily in the bonds of corporations.

Municipal Bond Funds invest in bonds issued by states and municipalities to finance public projects.

U.S. Government Income Funds invest in a variety of government securities.

Specialty Funds focus on a single industry sector or geographical area, such as pharmaceuticals or companies in "Pacific Rim" countries.

A fund seeks to attain its investment objectives by choosing a portfolio that fits its investment policies or strategies. A fund's portfolio has investment risk directly related to the securities it contains as well as to general market and business conditions. Regardless of the investment strategy or portfolio, no fund can escape market risk.

Tips on Buying Mutual Funds

Determine your financial objectives and how much money you can invest. Make sure the fund's objectives coincide with your own. Don't change your objectives or exceed the amount set aside for investment unless you have good reason.

Always obtain all available information before you invest. Request the prospectus, the Statement of Additional Information and the latest shareholder report from each fund you are considering.

Never invest in periodic payment plans unless you are certain you will not have to redeem early. If you redeem early or do not complete the plan, you may have to pay sales charges of up to 51 percent of your investment.

Be on the alert for incorporation by reference. You will have "no excuse" for not knowing this information if a problem arises. You may be presumed legally to know materials incorporated by reference in a prospectus or other documents.

Always determine all sales charges, fees and expenses before you invest. Fees such as 12b-1 fees can cost you dearly, and charges for reinvestment of dividends and capital gains distributions can add significantly to your costs. Shop around among the many funds offered and compare the various fees and costs connected with funds that appeal to you.

Learn the costs of redemption. Investors often are surprised to learn that they have to pay to get out of funds through back-end loads or redemption fees. Find out the redemption costs before you invest so you won't be surprised when you redeem your shares.

Never treat the risks of investment in a fund lightly. Weigh the risks of the funds you want to buy against your ability to tolerate the ups and downs of the market and your investment goals. Be extra cautious when considering investing in funds with high-yield/high-risk portfolios. Junk bond problems, for example, invariably affect the fund's performance.

Don't be misled by the name of a fund. Some funds have been given names denoting safety, stability and low risk, despite the fact that the underlying investments in the portfolio are volatile and risky.

Don't base your decisions solely on advertising and sales materials. Unlike the prospectus and the Statement of Additional Information (SAI), advertising and sales literature are not reviewed by the Securities and Exchange Commission before they are issued. The picture presented in a fund's advertisement may be rosier than that revealed by the prospectus and SAI.

Glossary

Back-End Load - Charge imposed by a mutual fund when an investor redeems shares. Redemption fees and contingent deferred-sales charges are examples.

Contingent Deferred-Sales Charges - Back-end load imposed on an investor who redeems shares. It is usually expressed as a percentage of the original purchase price or of the value of shares redeemed. In most cases, the longer the investor holds his shares, the smaller the deferred-sales charge.

Distribution - Payments made to shareholders by the mutual fund. Interest and stock dividends earned by the fund's portfolio are passed to shareholders as dividends, and capital gains are passed as capital gains distributions.

Dividend Reinvestment Fee - Fee charged when an investor uses dividends paid by a mutual fund to buy additional shares of the mutual fund.

Exchange Fee - Fee charged when an investor switches from one mutual fund to another in the same family of funds.

Front-End Load - Sales charge applied at the time the investor buys shares.

Investment Companies - The companies that pool investor money to buy securities.

Management Companies - There are two types: open-end and closed-end. Open-end funds, which sell and buy shares on demand, are called mutual funds. Closed-end funds have a fixed number of shares. After the initial public offering, shares in closed-end funds trade only on exchanges. The price is determined by the market and does not necessarily reflect the net asset value of the shares.

Management Fee - A fee paid by the mutual fund to its investment adviser and charged against fund assets, generally 1 percent or less per year.

Net Asset Value - In effect, the share price of a fund computed daily by adding the value of the fund's securities and other assets, subtracting liabilities and dividing by the number of shares outstanding. For a mutual fund with a front-end load, net asset value is identical to the "asked price" or "offering price."

Prospectus - This disclosure document should provide the investor with full and complete disclosure of all material information needed by the investor to make a decision whether or not to invest. The prospectus generally incorporates the SAI by reference. (See SAI definition.)

Redemption Fee - A fee charged to an investor who redeems shares. It is generally expressed as a percentage of the value of shares redeemed.

Rule 12b-1 Fee - An asset-based sales load, permitted by SEC Rule 12b-1, representing annual charges of up to 1 1/4 percent for specific sales or promotional activities of the mutual fund. Over time, the amount paid in Rule 12b-1 fees can surpass the amount paid in sales fees charged by load funds.

Statement of Additional Information (SAI) - A mutual fund is not required to furnish this disclosure document to investors unless investors specifically request it. Investors are responsible for knowledge of information in the SAI, even if they don't request it.

Total Return - A computation of mutual fund performance that measures changes in total value over a specified time period. Included in the computation are distributions paid to investors, capital gains distributions and unrealized capital gains and losses. Since all fund activity that has an effect on net asset value is represented, this measure provides a picture of performance that is more complete than yield.

Yield - A measure of mutual fund performance, which is figured by dividing the income generated (dividends, capital gains distribution, etc.) per share for a specific time period by the fund's current price per share. For example, if, during a year, a single share of a fund had paid income totaling $1 and its share price was $10, the annual yield for that year would be figured by dividing 1 by 10, which equals one tenth, or a yield of 10 percent.

If a problem arises

Contact the Securities Department at 1-800-332-6148 or (406) 444-2040 if you have questions about an investment opportunity or investment representative, or to report fraud. The department registers securities, brokerage firms, investment advisory firms and individuals working for those firms.

For more information on mutual funds and investing, contact your financial professional or investment company, or visit the State Auditor's Office Web site at http://sao.state.mt.us and click on its "Investor Resources" list.

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